Legislative Analysis

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UNIFORM PRINCIPAL AND INCOME ACT

House Bill 5154 (reported without amendment)
Sponsor: Rep. John Walsh
Committee: Tax Policy

Complete to 5-10-12

A SUMMARY OF HOUSE BILL 5154 AS REPORTED FROM COMMITTEE

The bill would amend the Uniform Principal and Income Act. This is a model act, developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL). **The act provides procedures for trustees administering an estate in separating principal from income.** As the Uniform Law Commission has testified, "trusts are often separated into income, which is distributed to current beneficiaries, and principal, which will eventually be distributed to remainder beneficiaries. The Uniform Principal and Income Act (UPIA) provides procedures for trustees administering an estate to separate trust assets into principal and income based on the intentions of the trust creator."

House Bill 5154 incorporates into the Michigan statute revisions to the model act approved by the NCCUSL in 2008. Two sections of the act are amended, Section 409 and Section 505. A new section, Section 606 is added for transitional purposes. The following is a summary of the 2008 amendments provided by the Uniform Law Commission. Other information can be obtained from the organization's website at:
http://www.nccusl.org/Act.aspx?title=Principal and Income Amendments (2008)

NCCUSL Summary

In 2008, the Uniform Law Commission finalized amendments to two sections of the Uniform Principal and Income Act (UPAIA). The amendments were drafted to clarify two discrete portions of the UPAIA, sections 409 and 505, and to provide a new transitional section 606 to facilitate the technical implementation of the amendments. The section 409 amendments should serve to resolve issues brought about by IRS Revenue Ruling 2006-26 and assist separate funds within a trust in qualifying for the IRS estate tax marital deduction safe harbors. The section 505 amendments should allow mandatory income trusts that own an entity to retain the proper amount of funds from distributions to meet their existing tax obligations. The amendments to the UPAIA have been adopted in 16 states to date, during the 2009 legislative sessions.

UPAIA Section 409: As an estate planning matter, sometimes a person designates a trust for the benefit of his or her spouse as beneficiary of his or her IRA or similar retirement plan ("a plan") rather than designating the spouse as beneficiary. This is most common when that person has children by a prior marriage or has a spouse who is incapacitated or for whom creditor protection or asset management is desired. Qualifying this trust for the federal estate tax marital deduction prevents estate tax from being incurred until the surviving spouse dies.

In 2006, the Internal Revenue Service (IRS) issued Revenue Ruling 2006-26, clarifying its opinion on when such a Plan payable to a trust qualifies for the marital deduction. This IRS ruling directly criticizes the UPAIA's original formula for allocating IRA distributions between principal and trust income. Revised section 409 is designed solely to put the UPAIA's provisions in line with the IRS' safe harbor requirements for qualifying trust income from a separate fund for the marital deduction. It should also be noted that the IRS Revenue Ruling states that the spouse must have the right to require that the plan's income be distributed to the trust, and that this income and income from other assets in the trust be distributed in turn to the spouse. The amendment expressly grants that right.

As a practical example of how the revised section works for income tax purposes, if a distribution is made from a Plan to a trust, the trustee is required to appropriately allocate that distribution between trust principal and trust income. The distribution is allocated to trust income to the extent that it represents the internal income of the Plan itself, and the rest is allocated to principal within the trust. The portion allocated to trust income is paid and taxed to the surviving spouse. The trust is subject to income tax on amounts retained as principal, but is not taxed on amounts paid to the spouse.

UPAIA Section 505: It is not uncommon for trusts that are required to pay income to a beneficiary to own an interest in an LLC or other "pass through" entity (an "entity"). The trust must report its share of the entity's income, whether or not the trust actually receives its entire share of entity income. Many such entities distribute to their owners only enough income to enable the owners to pay their tax obligations. They commonly reinvest the rest of the income in business operations. This strategy works well when the owners are individuals, but it can cause problems when the owners are mandatory income trusts.

As a practical example, suppose a trust has a 40% combined federal and state income tax rate and it is to be taxed on $100x of the entity's income. The entity distributes $40x to the trust to fund the tax obligation. If the trust is required to distribute the full $40x that it receives from the entity to the beneficiary, the trust will still be taxed on $60x of income ($100x minus the $40x that was distributable to the beneficiary), but will have no money from the distribution remaining to cover its share of the taxes. The beneficiary, as opposed to the trust, would still be liable for the taxes on the $40x distribution as normal.

The amendments to UPAIA section 505 provide a formula for calculating how much the trust needs to distribute and how much it can use to pay its resulting tax obligation. The proposed change clarifies that the trust will keep the money it needs to pay its taxes and distribute the balance of the income to the mandatory income beneficiary.

DISCUSSION AND COMMENTARY:

Testifying before the House Committee on Tax Policy, a representative from the Uniform Law Commission said,

Enacting the UPIA amendments contained in House Bill 5154 will ensure that Michigan law complies with current IRS regulations, and that Michigan residents will receive the full tax benefits to which they are entitled. There is no fiscal impact to the state. Thirty other jurisdictions have enacted these changes, which are widely supported by practitioners of trust and estate law.

FISCAL IMPACT:

The Department of Treasury testified that the bill would have no fiscal impact. (4-25-12)

POSITIONS:

The Probate and Estate Planning Section of the State Bar of Michigan testified in support of the bill. (4-25-12)

The Michigan Bankers Association indicated support for the bill. (5-2-12)

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